No. 8415

In the United States Circuit Court of Appeals for the Ninth Circuit

E. WAGNER AND SON, INCORPORATED, A CORPORATION
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The only previous opinion in this case is that of the Board of Tax Appeals (R. 12–28), which is unreported.

JURISDICTION

This petition for review involves income taxes in the amount of $1,333.44, and is taken from a decision of the Board of Tax Appeals entered July 6, 1936 (R. 28). The case is brought to this Court on a petition for review filed October 5, 1936 (R.29–34), pursuant to the provisions of Sections 1001,–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9,

109–110, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169, 286.

QUESTIONS PRESENTED

1. Whether there is any substantial evidence to support the Board's finding as to the amount which the petitioner may deduct for compensation allowed to its two officers during 1929.

2. Whether the petitioner may deduct the sum of $2,750 claimed as interest accrued on sums of money which were left with the petitioner by its officers during 1929.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, 28–30.

STATEMENT

The facts as found by the Board of Tax Appeals are as follows (R. 13–15):

The petitioner is a corporation of the State of Washington. At all times material to this proceeding, E. Wagner and his son, Otto H. Wagner, owned all of its stock in equal proportions. The former was president and the latter was secretary, treasurer, and general manager. They were also trustees or directors and devoted their entire time to the management of the petitioner's business. The petitioner's books were kept on an accrual basis (13).

E. Wagner and Otto H. Wagner held two meetings during 1929 for the purpose of considering the

compensation due them as petitioner's officers. They decided in June 1929 that they should receive an annual salary of $10,000 for that and subsequent years. They decided in September 1929 that they should each receive a bonus of $3,000 for services performed for 1929. No minutes or other written records were made of the action taken at these meetings (R. 13).

After the end of the year the petitioner in closing its books for 1929 made entries under the date of December 31, 1929, debiting officers' salaries in the amount of $26,000 and crediting E. Wagner with $13,000 and Otto H. Wagner also with that amount. The petitioner claimed a deduction in its return on account of compensation of its officers in the amount of $26,000. The Commissioner disallowed $20,000 of that amount (R. 13).

E. Wagner and Otto H. Wagner made loans to the petitioner prior to and during 1929, and in addition to those loans they left with the petitioner parts of their salaries for the years prior to 1929. Interest for the year 1929 on those amounts, computed at the rate of 6 per cent, amounts to $1,228.69. E. Wagner and Otto H. Wagner did not withdraw any of the salary or bonus authorized by the petitioner for the year 1929.[1] They did not have any meetings with reference to the allowance by petitioner of interest on any of the loans which they

[1] This statement may not be correct, as it appears that E. Wagner withdrew part of his salary. (See R. 60–61.)

made to it or the undrawn salaries or bonuses, nor did they as individuals ever enter into any agreement with the petitioner respecting the allowance or payment of interest thereon (R. 14).

The determination of the petitioner to allow interest on the amounts just referred to was first made in April 1930, when its books were being closed for the year 1929. At that time the petitioner made entries under date of December 31, 1929, debiting interest in the amount of $2,750 with the explanation that this was "interest accrued on loans from officers." It also credited E. Wagner with interest in the amount of $500 and Otto H. Wagner in the amount of $2,250. In its return for the year 1929, the petitioner claimed a deduction for interest in the amount of $4,759.53. The Commissioner disallowed $2,750 of this amount (R. 14–15).

As to the deduction for compensation to the officers, the Board stated that a reasonable allowance for salaries or other compensation for personal services actually rendered to the petitioner during the year 1929 is $4,000 in the case of E. Wagner and $10,000 in the case of Otto H. Wagner (R. 14). It accordingly held that the amounts claimed in excess of these sums should not be allowed as a deduction (R. 16).

As to the amount of interest to be deducted, the Board held that the petitioner failed to prove that it was entitled to deduct any larger amount than

that allowed by the Commissioner and accordingly limited the deduction to the amount of $2,009.53 (R. 16–17). It decided that there was a deficiency due in the amount of $1,333.44 (R. 28).

SUMMARY OF ARGUMENT

The Board of Tax Appeals properly refused to allow the petitioner to take a deduction for sums credited on its books to its two officers as bonuses for the year 1929 and for a portion of the sum credited to E. Wagner as salary for that year. The question presented is one of fact and as there is substantial evidence to support the Board's decision it should be affirmed.

The facts show that each of the officers had equal stock holdings in the company and that salaries and bonuses allowed them in 1929 were equal in amount. Such sums were large when compared with the profits of the company and were also excessive when compared with the compensation credited to them in former years when their duties were not materially different. The record shows further that no dividends have ever been paid although profits were realized. Under these circumstances, it is clear that the sums credited to the petitioner's officers were in fact a distribution of profits and were excessive. Accordingly, the amounts in question do not meet the statutory requirement of a reasonable allowance for services actually rendered and the deduction should be limited to the amounts allowed by the Board.

The Board also correctly refused to allow the petitioner to take a deduction for interest in the amount of $2,750 which it claimed was due to its two officers by reason of the fact that they had not withdrawn the full amount of their salaries during 1929 and prior years, but had left such amounts with the petitioner. The facts show that there was no agreement to pay any interest on the sums left with the petitioner in 1929 and it was not decided that an item for interest should be set up on the petitioner's books until April, 1930, when the petitioner's income tax return was being made up. It is evident that the petitioner's officers could have withdrawn their money at any time they wished to do so, and, although such sums may have been used by the petitioner, they did not constitute loans in the ordinary sense and certainly the petitioner is not entitled to take a deduction for interest which it never contracted to pay and which was allowed merely as an afterthought.

ARGUMENT

I

The Board's finding as to what constituted reasonable compensation for petitioner's officers is supported by substantial evidence and should be sustained

On its income tax return for 1929, the petitioner claimed a deduction of $26,000 on account of salaries and business accrued on its books as due to its two officers. After consideration the respond-

ent determined that the bonuses of $3,000 to each of the officers should be disallowed and that the allowance for salaries should be reduced from $10,000 to $3,000 for each officer. However, on appeal to the Board, the deduction as allowed by the respondent was increased since the former found that a reasonable allowance for salaries or other compensation for these officers would be $4,000 for E. Wagner and $10,000 for Otto H. Wagner (R. 14).

It is now our position that the Board's finding is not only fair to the petitioner but also that it is based on substantial evidence and is in accord with well established principles of law.

The Revenue Act of 1928, which is applicable here, allows deductions only for ordinary and necessary expenses incurred in business, and, in including salaries or other compensation as deductible expenses, the statute has not only restricted deductions for compensation to that paid for personal services actually rendered but has also limited them to a reasonable allowance. (Section 23 (a), Appendix, *infra,* p. 28.) The Treasury Regulations issued pursuant to this statutory provision provide that the test of whether salary is deductible is whether it is reasonable and is in fact a payment for services actually rendered. As to bonuses, the regulations state that the test is whether the bonus has been paid in good faith as additional compensation for personal services and if, when added to the salaries

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regularly paid, the whole sum is not excessive in amount (Articles 126 and 128 of Regulations 74, Appendix, *infra,* p. 29).

In contending that a deduction should be allowed for salaries and bonuses paid, the taxpayer has the burden of proof. *Botany Mills* v. *United States,* 278 U. S. 282; *Twin City Tile & M. Co.* v. *Commissioner,* 32 F. (2d) 229 (C. C. A. 8th); *Weed & Bro.* v. *United States,* 38 F. (2d) 935 (C. Cls.), certiorari denied, 282 U. S. 846; *A. David Co.* v. *Grissom,* 64 F. (2d) 279 (C. C. A. 4th).

While as a matter of general law, directors of a corporation may decide if services have been rendered, and may make contracts paying a large salary for such services, the Federal government is not bound by any resolution of a board of directors. Moreover, salary payments as shown by a corporation's books are not conclusive as against the Government. *Becker Bros.* v. *United States,* 7 F. (2d) 3 (C. C. A. 2d); *H. L. Trimyer & Co.* v. *Noel,* 28 F. (2d) 781 (E. D. Va.).

The question of whether a salary or bonus is a reasonable allowance and so deductible is a question of fact. *Sunset Scavenger Co.* v. *Commissioner,* 84 F. (2d) 453 (C. C. A. 9th); *General Water Heater Corp.* v. *Commissioner,* 42 F. (2d) 419 (C. C. A. 9th); *Austin* v. *United States,* 28 F. (2d) 677 (C. C. A. 5th); *United States* v. *Philadelphia Knitting Mills Co.,* 273 Fed. 657 (C. C. A. 3d); *Becker Bros.* v. *United States, supra.* In deciding this question, the Board of Tax Appeals must necessarily exercise

its own judgment, and will not be required to ascertain a reasonable allowance with mathematical precision. *Tumwater Lumber Mills Co.* v. *Commissioner,* 65 F. (2d) 675 (C. C. A. 9th); *Atlas Plaster & Fuel Co.* v. *Commissioner,* 55 F. (2d) 802 (C. C. A. 8th).

Since profits may be distributed as salary or as a bonus, it is proper to consider if the payments are in proportion to the stockholdings or if in other ways they appear to be distributions of profits. *Twin City Tile & M. Co.* v. *Commissioner, supra; Marble & Shattuck Chair Co.* v. *Commissioner,* 39 F. (2d) 393 (C. C. A. 6th). Also, if there have been large increases in salary, the Board is justified in requiring what it considers to be a satisfactory explanation of the increase. *Tumwater Lumber Mills Co.* v. *Commissioner, supra.* As to opinion evidence that a salary is reasonable, this is not binding on the Board if the latter does not see fit to accept it. *Am-Plus Storage B. Co.* v. *Commissioner,* 35 F. (2d) 167 (C. C. A. 7th). Also, it is well established that the Board's findings may not be reversed on appeal because of a difference of opinion as to the weight of that evidence, and that its decision should be sustained if there is any substantial evidence to support it. *Botchford* v. *Commissioner,* 81 F. (2d) 914 (C. C. A. 9th); *General Water Heater Corp.* v. *Commissioner, supra.*

Applying these principles to the instant case, we submit that it is evident that the Board's decision in the instant case is based on substantial evi-

dence. The petitioner had the burden of proof but called only three witnesses by which to prove its case. Two of these were the Wagners who are the petitioner's sole stockholders and whoe salaries are here in question. The third was Mr. Carne, a part time bookkeeper, who has made up the petitioner's income tax return since its incorporation in 1924. In preparing the tentative return for 1929 which was signed by Otto H. Wagner, Mr. Carne gave the salaries of the Wagners as aggregating $6,000. As to this he testified that later when he was told that that figure should be increased to $26,000 he "was a little surprised" (R. 37).

As to the salaries which the petitioner had allowed its officers in prior years, Mr. Carne testified that in 1924 each officer was given $2,000. That was also the salary of each in 1925. In 1926, their salaries were increased to $4,000 but in 1927 they dropped back to $2,000 and that was also the amount allowed in 1928. Then he was told in 1930 when he was preparing the petitioner's return that salaries and bonuses for 1929 should be given as $13,000 for each officer (R. 35–37).

Mr. Carne expressed no opinion as to the propriety of such increases. Accordingly, the only opinions given are those of the two men to whom the salaries were to be paid. They each stated, in substance ,that $13,000 was a reasonable allowance for their services in 1929 (R. 49–50, 59), but

as it was to their obvious advantage to make such statements, the Board was undoubtedly justified in not giving their opinions the weight they might have deserved had they come from disinterested persons. Especially is this true in the absence of any showing as to what other officers in companies of similar size and kind were paid and in view of other evidence in the case which does not support the petitioner's contention that the deduction as claimed is reasonable.

From the figures given above as to salaries, it will be seen that the compensation claimed for each in 1929 is not only more than six times the salary of each officer for 1928, but it is also $1,000 more than the total amount which either had been allowed during the five preceding years. Thus the amount allowed for 1929 clearly appears to be excessive when compared with these prior years. The petitioner contends otherwise by claiming that the salaries for the earlier years were inadequate and that conditions had so changed by 1929, the large increase was justified. But we do not agree.

As to the prior years, the petitioner has failed to show what compensation was being paid for similar work in other companies during those years, or to produce any other evidence which would indicate what reasonable salaries would have been. Thus we have no adequate test by which to judge the salaries of the Wagners for earlier years. But even assuming as the petitioner contends, that

the company was financially unable to pay larger salaries in those years and that its business increased in 1929, still we maintain that the petitioner was not justified in paying as large an amount as the Wagners agreed upon.

Although the petitioners did have what its officers called a big year in 1929, yet it was still a comparatively small company in that year and its operations were not extensive. When the petitioner was organized in 1924, its equipment and plant were only worth between $15,000 and $20,000. Moreover, the box manufacturing business was a new field to the Wagners, and as they lacked experience and capital, the operations of the company were necessarily small at first (R. 42). The Wagners testified that the plant had been enlarged and new equipment had been installed (R. 56, 61), but judging from the amount of money which they indicated that they were able to borrow or to advance themselves, the value of such improvements could not have been great. Thus, even with its enlarged plant, it is evident that petitioner could not be considered a large company in 1929.

It is true that petitioner's gross sales had increased steadily since its organization in 1924 but the increase for 1929 was only about 45 per cent over 1928 (R. 36, 83), whereas the increase in compensation for each officer in 1929 was 550 per cent more than had been paid each one in 1928. Moreover, even though the Wagners stated that they

considered 1929 a successful year, they also admitted that they continued to have difficulties in securing enough money to run the business. Their testimony shows that such difficulties were experienced not only in getting money for capital investments but also in borrowing enough money to meet the current expenses of 1929 for the petitioner's financial status was such that it could not get more than $15,000 from outside sources during 1929 (R. 44, 53, 60–61). Thus we see that the petitioner was not in a position to pay such large salaries even in 1929. Moreover, it appears that the Wagners knew this for even though they agreed to allow themselves $13,000 each for 1929, actually they took only part of that amount in cash, and so acted just as in former years when they had not withdrawn all of the amounts credited to them on the petitioner's books. Such action on the part of the Wagners is, we submit, a strong indication that the amounts agreed upon for 1929 were larger than the petitioner could afford to pay.

There is a further factor to be considered here in connection with the petitioner's business for 1929 and that is the nature of the duties rendered by the officers in that year. Considering first the services of Otto Wagner, we find that he was actively in charge of all of the petitioner's sawmill and manufacturing operations and handled most of the sales. However, from his own description of his work, it does not appear that it changed mate-

rially in that year except for longer hours (R. 44). The increased hours were due to the fact that beginning June 1, 1929, and going through to October or November, the petitioner ran a double shift at its plant (R. 43–44, 51). However, on one shift, the petitioner had a superintendent who was in charge and of course could relieve Wagner of some of the work (R. 55). Moreover, these long hours did not last throughout the year for the business of petitioner is seasonal, being carried on for not more than eight months of a year, and begins in April (R. 52). Thus the salary allowed Otto Wagner for 1929 was really for work which was full time for only eight months and which was on a double shift for only part of that time. Consequently, even though we assume that Otto Wagner's duties were heavier in 1929, we believe that, in view of the foregoing facts, the Board was justified in determining that reasonable compensation for Otto Wagner was $10,000. Certainly, as this was 400 per cent more than he received in 1928, such allowance is a generous one.

While the petitioner bases a part of its argument on the salary received by its superintendent (Br. 11), we do not see how this should effect the finding made by the Board. The testimony shows that the superintendent received about $7,000 in salary during 1929 (R. 55). Otto Wagner stated that such amount consisted of $3,600 paid as salary, $600 as a bonus, and a contract for an interest in

the mill property on which the superintendent was allowed a credit of about $3,000 (R. 54). There is no other testimony as to the superintendent's salary and so we do not know how the value of the contract was determined. Moreover, in testifying as to this, Otto Wagner did not seem very sure as to the exact amount of the bonus or of the total sum but assuming that the figures he gave are correct, we submit that even judged by the superintendent's salary, the Board's allowance to Otto Wagner is still a fair and reasonable amount.

As to the compensation allowed to the father, E. Wagner, who was 74 years old in 1929, we think the Board's allowance of $4,000 was also a fair one under the circumstances of this case. He testified (R. 57–58, 60) that his health began to break down in July 1929, that he had to quit work entirely a little later on, and that he left the country for an ocean voyage on October 1st and did not return until June 1930. His duties during the seven months of 1929 which he worked related largely to the subdividing of a tract of land which was formerly an orchard, to selling of lots therefrom, and to building small, inexpensive cabins and houses when the lots could not be sold otherwise. He also made trips once or twice a week to the petitioner's manufacturing plant, and sometimes went on scouting trips for timber. While the son testified (R. 55) that he and his father put in more time than their superintendent in 1929, we must

assume that the father knew more about his hours of work than his son and the former stated that the superintendent put in more time in 1929 than he did (R. 58). Also the father did not indicate that his duties were any heavier than they were in prior years and we cannot, of course, assume that they were. On the other hand, we may assume, in the absence of a contrary showing, that in such years he gave his full time, whereas in 1929 we know that he put in only seven months and part of that time he was partially incapacitated by illness (R. 60). The petitioner has stated (Br. 10) that Mr. E. Wagner could have earned more than $13,000 in other lines of work but that assertion is based merely on Wagner's statement (R. 59) and was given without any facts as to offers which he had received or actual possibilities. But even if it is true, that does not mean that the compensation due him for seven months' work from petitioner should have exceeded the $4,000 which the Board allowed. That amount is an increase of 100 per cent over the preceding year and is a reasonable allowance for the services rendered.

In considering the reasonableness of the Board's allowance for compensation, it should also be noted that E. Wagner and Otto Wagner were the sole stockholders of the petitioner, that they owned an equal amount of stock, and that the petitioner declared no dividends in 1929 although it found that it was possible to allow each of its officers

an increase in compensation of 550 percent (R. 13, 52). As the petitioner had never declared any dividends, it is, of course, evident that the only way any of its profits had ever reached its two stockholders was by way of salaries and bonuses. As the amounts credited to each one in 1929 were equal, the salaries were allowed in the same proportion as dividends would have been paid, if declared, and so we submit were in part a distribution of profits. We find further support for this conclusion in the testimony of Otto Wagner, indicating that the increase in compensation was determined by the profits which they expected to make. Thus he explained that when in June of 1929 he and his father realized they were going to have a big year, they decided to increase their salaries to $10,000 and later they decided also to take a bonus of $3,000 each (R. 45–46, 52).

In view of the evidence referred to above, we submit that there is ample basis for the Board's finding as to what constitutes a reasonable allowance for compensation and so its determination should be sustained.

II

The deduction now claimed by the petitioner for interest should be denied because it has not been shown that there was a valid obligation to pay interest or, if there was, what the correct amount of interest should be

On its income tax return for 1929, the petitioner took a deduction of $4,759.53 for interest accrued

on its books for that year. The respondent determined that such deduction should be limited to $2,009.53 and the Board sustained his determination (R. 17). Thus the amount disallowed by the respondent and in issue before the Board was $2,750 and that is also the amount involved on this appeal (R. 5, 14, 16, 31 [2]).

The burden of proof was also on the petitioner on this point and to sustain its burden it should have shown that this item of interest had either been "paid or accrued within the taxable year" (Section 23 (b), Appendix, *infra,* p. 28). As it was never claimed that any of this interest was paid, it was of course necessary for the petitioner to show that the interest was accrued within the statutory meaning. Obviously, this requires more than production of a mere book entry for it is fundamental that no interest may be accrued unless it has become vested, and it will not be vested unless there is a legal obligation to pay interest since interest is not a mere gratuity. Moreover, even when there is a valid obligation, no sum should be accrued as interest unless the evidence shows that it is the correct amount due. This means that evidence should

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[2] Assignments of error (5) and (14) refer to the amount of interest disallowed as $2,906.22 and assignments (6) and (15) to the amount as $1,743.73 (R. 32–33). These assignments are misleading as they indicate that the Board made findings relative to such amounts. Instead, its findings on the interest question referred only to the item of $2,750, which was the amount referred to in the petition before the Board (R. 5).

be produced to show what the correct amount is and such evidence should include the amount of the loan on which the interest is due, the rate of interest, and the length of time within the year which the loan covers. The petitioner did produce some documentary evidence but the figures therein are partially contradicted by statements of the Wagners and its evidence is not complete. Thus it has failed to meet its burden and is not entitled to any deduction for interest in addition to that allowed by the Board.

Taking up first the matter of whether there was any obligation on the part of the petitioner here to pay this interest, it is our position that it was not so obligated. The item of $2,750 was an entry on petitioner's balance sheet dated December 31, 1929, and it appears over an explanation that this is "interest accrued on loans from officers" (R. 98). But this entry was not made until April 1930, when Carne closed the petitioner's books. The amount of $2,750 was given to Carne at that time by Otto Wagner, who said that it represented interest at the rate of 10 percent (R. 14, 41, 49). It is of course well established that bookkeeping entries are not conclusive and that they must yield to the real facts. *Gulf Oil Corp.* v. *Lewellyn,* 248 U. S. 71; *Landers Bros. Co.* v. *Commissioner,* 60 F. (2d) 85 (C. C. A. 6th). Certainly this entry should not be conclusive for it was not made until more than three months after the end of the tax year. At that time the petitioner's income tax was also being

computed so the question of deductions was undoubtedly then uppermost in the minds of the interested parties. Thus the matter of interest was an afterthought and was adopted after the expiration of the year in an apparent attempt to decrease taxes. Being an afterthought, and not pursuant to an agreement, it is evident there was no obligation to pay interest. This is shown by the evidence.

Otto Wagner testified that the petitioner had no agreement to pay this item of interest (R. 54). Moreover, he admitted that the matter of allowing such interest was not decided until his trip to Seattle in April 1930, to see Carne, who was closing the petitioner's books and making up its income tax return (R. 37, 49), and Carne testified that there were no entries in the petitioner's books relative to an agreement to pay interest (R. 41). Based on this evidence, the Board found that there was no agreement on the part of petitioner here to pay interest to its officers (R. 14). Consequently, we conclude that since the petitioner had not agreed to pay, it had no obligation to pay interest and any allowance it might make would be merely a gratuity and not deductible.

Interest is the amount one contracts to pay for use of borrowed money. *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552. Interest cannot be charged unless it is the subject of an express agreement or is specifically allowed by statute or by some well established business custom. *Young* v. *Canfield,* 33 Cal. App. 343; *Totten* v. *Totten*, 294 Ill.

70; *Clark* v. *Giacomi,* 85 Colo. 530, 536; *Sargent* v. *American Bank and Trust Co.,* 8 Ore. 16, 46. In the instant case, neither the state law [3] nor any custom specifically allows such interest and since there was no agreement, none may be allowed.

A similar question was presented in *Miller Safe Co.* v. *Commissioner,* 12 B. T. A. 1388, in which, as here, a stockholder advanced money to his corporation without any agreement as to interest. It was held there that the corporation was not obligated to pay interest and should not be allowed to deduct for it in its tax return, even though it paid the stockholder for the use of the money, since such allowance on the corporation's part was a gratuity.

In another case, a partner left his share of the partnership's profits in the business without any agreement as to interest thereon. Later when the partner sued and an accounting was ordered, it was held that he could not recover any interest on the money advanced. See *Dugan* v. *Forster,* 104 Cal. App. 117.

We submit that these cases state the correct rule and that the petitioner must fail because of the lack of an agreement. It seems strange that the

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[3] Petitioner claims that Section 7299, Vol. II, of Remington's Compiled Statutes of Washington requires the payment of interest here, but it appears that that section applies to loans which are made pursuant to express contracts but in which no rate of interest is named, whereas here there was no agreement of any kind. For the subject matter of Section 7299, see petitioner's brief, p. 20, or Record, p. 24.

petitioner should now be contending that interest was due the Wagners. The latter knew the petitioner's financial difficulties and undoubtedly never intended to charge interest when their money was left with petitioner. Such sums were always subject to withdrawal at the pleasure of either officer and throughout 1929 withdrawals were made frequently as will be seen from an examination of the accounts of the Wagners with the petitioner (R. 101–102) and also from their testimony (R. 53, 60). Obviously, there was nothing definite or settled about the amounts or the length of time which these sums would remain with petitioner, and they were not meant to be interest bearing loans.

In disallowing the deduction, the Board found that there was no evidence to indicate that any part of the salaries or bonuses was payable prior to the end of 1929 and that, in the absence of such proof, there was nothing to show that the petitioner was entitled to any larger deduction for interest than that allowed by the Commissioner (R. 17). We submit that the Board's finding as to the evidence is correct. The Wagners testified as to the yearly sums they voted themselves but did not state how they were to be paid. Obviously it is true that if the salaries and bonuses were not due before the end of the year, and there is no evidence otherwise, then the petitioner did not use any part of such sums in 1929, after they were payable to the Wagners. Thus no interest would be due on account of 1929 salaries and bonuses.

However, assuming for the sake of argument that the petitioner could take a deduction for interest without an agreement to pay it, and that the salaries and bonuses were payable before the end of the year, the deduction here should still be denied because the petitioner has failed to show what the correct amount of interest would be. The petitioner now admits (Br. 17–18) that $2,750 is not the correct amount and asserts that such amount is either $2,906.02 or $1,743.73, depending on whether interest is allowed at ten per cent or six per cent. The petitioner is of course in error in urging interest at ten per cent, for in cases like this one where the rate is not set out in a written agreement, the law of Washington prohibits interest higher than the legal rate, which is six per cent. *Hart* v. *Steele,* 168 Wash. 336; *Connecticut Investment Co.* v. *Yokon,* 106 Wash. 693; *Sandberg* v. *Scougale,* 75 Wash. 313.

Thus we can eliminate both $2,902.02 and $2,750 since these amounts are supposed to represent interest at ten per cent. We must also eliminate the sum of $1,743.73, for it is obvious when the testimony of the Wagners is compared with the bookkeeper's computation of interest that sum is not a correct amount. This item of $1,743.73 represents $515.04 claimed as interest on 1929 salaries and bonuses and $1,228.69 claimed as interest on advances made by the Wagners in 1929 and prior years (R. 101–102).

Taking up the $515.04 item first, it appears from the bookkeeper's interest exhibits (R. 101–102) that both of the Wagners left all of their salaries and bonuses with the petitioner throughout 1929. Thus interest was figured on the full $26,000 up until December 31 of that year. However, E. Wagner testified that he drew $5,000 of his 1929 salary to get a steamship ticket in September 1929 (R. 60–61). Also Otto Wagner stated that in 1929 he and his father withdrew such money as they needed for living purposes and that his own withdrawals were about $2,500 (R. 53). Otto Wagner did not state that the latter withdrawals were from the 1929 salaries. Neither did he say that they were not. Thus it is as reasonable to assume that they were as that they were not, and as the petitioner has the burden of proof, he should have shown the source and amount of the sums on which it is claiming interest.

At any rate it is true that part of the withdrawals were from the 1929 salary fund, and it was wrong for the bookkeeper, in estimating the amount on which interest was due, to include the entire sum allowed for salaries and bonuses. Moreover, as the record does not show the date on which such sums were payable, the actual amount of money withdrawn by the Wagners, or the exact time of the withdrawals, the extent of the bookkeeper's errors cannot be determined at this time. So having failed to produce the evidence necessary to estab-

lish its claim for $515.04 in interest or any other amount, the petitioner must now be denied the right to deduct anything for interest on salaries and bonuses for 1929.

There is also uncertainty and insufficient proof in regard to the other interest item of $1,228.69 which consists of $147.37 claimed as due E. Wagner and $1,081.32 as due Otto Wagner on salary left by them from prior years and also for some outright advances made by them (R. 38, 101–102). From the balances listed as due the Wagners throughout 1929, it appears that only a small part of such advances were made by the Wagners to the petitioners during 1929. (See first 12 items on the exhibits, R. 101–102.) This should be noted specially because the petitioner has definitely indicated in its petition for review in this Court that the interest now in question does not relate to advances or salary left from other years and explains that the respondent allowed interest on those amounts (R. 31). Accordingly, it seems apparent that we should at once eliminate from the above items such portion as represents interest on advances made in the prior years. From an examination of the interest exhibits (R. 101–102), it will be seen that this would take up most of the $1,228.69 and so that figure should be greatly reduced, but in the absence of evidence as to the exact date when the advances were made, the correct amount cannot be computed.

There is no reason why we should not adopt the statement in the petition for review that interest for prior years was allowed as a deduction. The record shows that the Commissioner allowed a deduction for interest in the amount of $2,009.53 (R. 16). We also know that such amount exceeds the amount of interest due on outside loans to petitioner during 1929 for such loans did not exceed $15,000, and the interest, being paid partly at eight per cent and partly at ten per cent, could not have exceeded $1,500 (R. 44, 49, 60). So it follows that the difference between the interest paid outsiders and the amount allowed by the Commissioner must represent interest due to the petitioner's officers on the advances made in prior years. Thus the petitioner has already received what we believe to be a generous allowance on its interest claim, and one which, if it had been litigated, would doubtless have been refused because of the absence of any valid obligation to pay. Certainly, even if the petitioner is entitled to deduct interest, it should not be allowed any additional deduction now in view of its failure to produce evidence from which a correct computation of interest can be made.

Therefore, the Board, properly refused to allow either of the deductions claimed by petitioner, and it is immaterial that the Board's reasons for disallowing the interest item are not in all respects the same as those advanced by the respondent as it reached the correct decision. *Dickey* v. *Burnet,*

56 F. (2d) 917 (C. C. A. 8th), certiorari denied, 287 U. S. 606.

The petitioner has given a recomputation of the tax in its brief (p. 21) as it contends it should be if the Board's decision is reversed. We do not consider that this is a matter to be discussed here but do call attention to the fact that the petitioner is in error in figuring the tax at 11 per cent since the rate given in the 1928 Act is 12 per cent. (Section 13 (a), *infra*, p. 28.)

CONCLUSION

The Board's decision should be affirmed.

Respectfully submitted.

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APRIL 1937.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 13. TAX ON CORPORATIONS.

(a) *Rate of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax of 12 per centum of the amount of the net income in excess of the credits against net income provided in section 26.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1927, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title.

SEC. 26. CREDITS OF CORPORATION AGAINST NET INCOME.

For the purpose only of the tax imposed by section 13 there shall be allowed the following credits:

* * * * *

(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $3,000; but if the net income is more than $25,000 the tax imposed by section 13 shall not exceed the tax which would be payabe if the $3,000 credit were allowed, plus the amount of the net income in excess of $25,000.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 126. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the

excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. * * *

* * * * *

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

ART. 128. *Bonuses to employees.*—Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and other, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are not deductible from gross income.

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